THE SOCIAL SECURITY EARNINGS TEST AND OLDER WORKERS

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SUMMARY

Introduction. One of the obstacles facing older workers is the Social Security earnings test, which imposes some of the highest tax rates in the economy. A beneficiary aged 62-64 loses $1 in benefits for every $2 in earnings once earnings pass a limit of $11,280 – effectively a 50% marginal tax rate, since total income rises by only a dollar when earnings rise by two. Moreover, evidence from my research suggests that older workers, who are on the brink of retirement, are more sensitive than younger workers to high tax rates.

There are two additional features of the earnings test that are perverse:

- First, it is a tax that raises virtually no revenue. Suppose a 62-year old beneficiary works so much in a year that her entire benefit is lost to the earnings test. In that case, all her future benefits will be raised by about 7% – the same thing that would happen if she had waited another year to claim Social Security. Over her remaining lifetime, this gain in the expected present value of future benefits will approximately make up for the year of benefits lost earlier. Yet, most beneficiaries are unaware of this adjustment to future benefits and act as if they were facing a pure tax. The other side of the coin is that the Social Security Trust Fund gains in the short-run from paying out less in benefits but loses an equivalent amount in the long-run. Thus, while the immediate costs of relaxing or eliminating the earnings test are substantial, the long-run costs approach zero.

- Second, the earnings test applies only to workers younger than Social Security's full retirement age (which is now 65 years and a few months). Therefore, workers face a high tax from the earnings test for a few years and may reduce their labor supply as a result. Later on, it is often difficult to ramp up hours in a part-time job or to re-enter the labor force after retiring, so the effect on labor supply may be the same as if the earnings test were imposed on beneficiaries of all ages.

In past research, I have analyzed how the earnings test affects older workers. Today, I will describe the conclusions of my earlier study. After that, I will discuss research by others, as well as more recent evidence that I have collected about how the earnings test continues to affect older workers.

My earlier research on the earnings test. In a study published in 2000, I analyzed how beneficiaries changed their hours of work as the earnings test rules changed. Earlier rule changes revealed significant responses to the earnings test. In my research I used large data files in which people report their earnings and hours of work. Many workers in these surveys responded noticeably by restricting their hours of work so that their earnings stayed just at or below the earnings test limit.

For example, in 1983 the earnings test was eliminated for people aged 70-71. Before that, many of them kept their earnings just at the earnings limit. Afterwards, their earnings smoothed out, so we can conclude that they had been restricting their work hours because of the earnings test. Earlier, in 1978, the earnings limit was raised from $3,000 to $4,000 for people aged 65-71. In the data, we can see the cluster of workers with earnings just below $3,000 move their earnings up to the new higher limit. These shifts provide evidence that older workers are sensitive to high taxes.

Based on these past responses, I used statistical methods to predict how hours of work would change if the earnings test were eliminated for ages 65-69. These predictions focus on hours of work among males who were already working. After I conducted the study, the earnings test was in fact eliminated in this age range, but data to compare my simulation results with actual responses is not yet available.

The predictions differ in important ways, depending on how much someone works and earns:

- Low earners, who keep their earnings just at or below the earnings limit, react most visibly to the earnings test and would be the most responsive to a change. Compared to their actual hours of work in 1995, they would be predicted to work 50% more on average, if the earnings test were eliminated.

- Medium earners, who are working somewhat more initially and lose some but not all of their benefits, might, in theory, work more because the tax imposed by the earnings test is eliminated, or they might work less because eliminating the earnings test raises their total income. Compared to their actual hours of work in 1995, and based on their earlier responses to the earnings test, the simulations predict that they would work 18% more on average, if the earnings test were eliminated.

- High earners, who work so much that they lose all of their benefits, would be induced to work less, not more. This occurs because they would receive extra income but face no change in their effective tax rate, since they were already earning too much to lose additional benefits. They would be predicted to work 4% less on average, if the earnings test were eliminated.

Next, I will discuss research by others on the earnings test, and then evidence of how the earnings test continues to affect older workers.

Research by others on the earnings test. Another recent study has taken a different approach to analyzing the earnings test. Jonathan Gruber of MIT and Peter Orszag of The Brookings Institution used the same data but reached somewhat different conclusions. They combined together all of the groups whom I just mentioned – low, medium, and high earners – to analyze whether overall labor supply changed.

Gruber and Orszag's key conclusions are the following. First, they suggested that the earnings test has little effect on hours of work. On the face of it, this contradicts my findings, but it may be attributable to a major drawback with their approach, which does not distinguish whether large responses among individuals are being obscured in the aggregate. Why is this important? We might reach very different conclusions if eliminating the earnings test induces no response by individuals, or instead if it induces large but offsetting responses. In the latter case, even though the earnings test leads some high earners to work less, the gain in well-being among low and medium earners who work more is substantial. My results showed that low earners who kept their earnings just at the earnings test limit were made worse off by an amount equivalent to over $1,900 by the earnings test. Thus, it is important to know how individuals, and not just average labor supply, is affected.

Second, Gruber and Orszag found that the earnings test may induce some people to retire. Later on, I discuss some additional evidence supporting this conclusion. This is an important result for two reasons. First, if the earnings test also affects retirement, then estimates focused on hours of work understate its impact. Second, it tells us something important about how the labor market works – in particular, that people may not be able to choose their jobs and their hours very precisely.

Third, Gruber and Orszag argued that eliminating the earnings test for workers aged 62-64 would have a pernicious effect down the road on some people who would benefit from it at the outset. This argument is based on the adjustment to future benefits discussed earlier – if the earnings test is eliminated, those who would have lost benefits today, and also those deterred from claiming early today, would no longer get higher benefits in the future. The concern is that they would end up impoverished at a very old age. This argument rests on the following assumptions: that workers would prefer to save some or all of the higher benefits that they would get today if the earnings test is eliminated to consume at older ages, but that they would not actually save them, perhaps because they lack the means or the foresight. If those assumptions hold, then we could make them better off by getting them to save through the earnings test, but otherwise if they do not hold, then forcing them to postpone receiving benefits makes them worse off. Those are controversial assumptions about which we have little firm evidence. Another way to address the same concern – that too many beneficiaries would be induced to claim too early if the earnings test is eliminated – would be to try to explain to beneficiaries how Social Security works, and in particular that the return to delaying claiming benefits is substantial.

Recent effects of the earnings test. In preparation for this Forum, I have analyzed recent data on the impact of the earnings test. I find the following:

- Workers aged 62-64 continue to react to the earnings test by keeping their earnings just below the earnings test limit, at the same time that more people at those ages are working instead of retiring. Moreover, women are reacting a little more strongly than men. Interestingly, increases in the real value of the earnings limit after 1996 led to a little less clustering of earnings at the limit, so workers continue to show responsiveness to changes in the earnings test.

- I have mentioned a few times that the earnings test may lead some people to retire altogether. I have found preliminary evidence in support of this. While there was little trend in retirement among workers aged 60-61 during the 1990s, retirement rates fell among workers aged 62-64. The percentage of male workers aged 62-64 who retired each year fell significantly, from about 25% to 20%, while the percentage of female workers fell from about 25% to 15%. Moreover, the earnings test limit for this age group rose from about 1996 on, the same time period over which the decline in retirement rates was concentrated. This demonstrates that eliminating the earnings test may lead to delays in retirement.

Conclusions. My research shows that the earnings test leads some beneficiaries to reduce their hours of work and perhaps to retire. This is not the only reason people retire early, but it has an effect. I will briefly summarize other research I have done on factors influencing retirement:

- Older workers who learn to use a computer retire later, on average, than older workers who do not. Yet, theory suggests that firms may be reluctant to train older workers, since they do not know when the workers will choose to retire.

- Older workers are engaging in part-time work at increasing rates, suggesting growing flexibility of the labor market in response to the needs and wishes of older workers.

- Shifts in the structure of private pensions are having a major effect on retirement. Workers with defined contribution pensions, like 401(k) plans, are retiring two years later, on average, compared to workers with traditional defined benefit pensions, which required workers to stay in a job 20-30 years to gain a substantial pension but then deterred additional work. It is also possible that the switch to defined contribution pensions will encourage older workers to take new, short-term jobs before retiring fully.

I will be happy to answer questions about my research on the earnings test and other factors affecting retirement.

BACKGROUND

Introduction

When Social Security was established during the Great Depression, one motive was to encourage older workers to leave the labor force and make way for younger workers. Thus, the system was designed not simply to give benefits to older workers, but also to condition benefits on retirement.

In the decades since, the typical retirement age of older workers has plummeted. The proportion of men aged 65 and over working or looking for work fell from 46% in 1950 to 17% in 1999. With life expectancy continuing to rise, the work force shrinking, and savings rates at an all-time low, the increasing length of retirement is now viewed as unsustainable.

To ease the penalty against working, the earnings test was gradually liberalized beginning in the 1950s, principally for people aged 65 and over. Most recently, the "Senior Citizens Freedom to Work Act of 2000" eliminated the earnings test for workers above the full retirement age (which is gradually increasing from 65 to 67). Beneficiaries aged 62-64 face a 50% tax rate for earnings above a limit of $11,280 – effectively a 50% marginal tax rate, since total income rises by only a dollar when earnings rise by two.

There are two additional features of the earnings test that are perverse:

- It is a tax that raises virtually no revenue. Suppose a 62-year old beneficiary works so much in a year that her entire benefit is lost to the earnings test. In that case, all her future benefits will be raised by about 7% – the same thing that would happen if she had waited another year to claim Social Security. Over her remaining lifetime, this gain in the expected present value of future benefits will approximately make up for the year of benefits lost earlier. Yet, most beneficiaries are unaware of this adjustment to future benefits and act as if they were facing a pure tax. The other side of the coin is that the Social Security Trust Fund gains in the short-run from paying out less in benefits but loses an equivalent amount in the long-run. Thus, while the immediate costs of relaxing or eliminating the earnings test are substantial, the long-run costs approach zero, since future benefits will not be raised as they are today to make up for current benefits lost to the earnings test.

- The earnings test applies only to workers younger than Social Security's full retirement age (which is now 65 years and a few months and is gradually rising to 67). Therefore, workers face a high tax from

the earnings test for a few years and may reduce their labor supply as a result. Later on, it is often difficult to ramp up hours in a part-time job or to re-enter the labor force after retiring, so the effect on labor supply may be the same as if the earnings test were imposed on beneficiaries of all ages.

My earlier research on the earnings test

In a study published in 2000, my strategy was to investigate several recent changes in the earnings test rules (Friedberg 2000, Friedberg 1998). Some earlier researchers had concluded that gradual liberalization of the earnings test rules meant that the earnings test no longer "bites". They suggested that the earnings test no longer leads people to retire and has little effect on their hours of work. Two major problems arise with those earlier studies. They did not analyze data from after the 1970s, so previous results may be outdated. Also, no major changes in the earnings test rules occurred during the period studied in earlier research.

It is easy to understand how people are influenced by the earnings test by observing how they respond when it is altered; otherwise it can be more difficult, since work decisions are shaped by many factors which we cannot observe and which change over time. The data I used showed a strong response among workers to past changes in the earnings test, suggesting similar reactions if the earnings test were eliminated today. While the short-run costs of relaxing the earnings test would be substantial, the long-run costs are close to zero, since future benefits will not be raised as they are today to make up for current benefits lost to the earnings test.

The impact of the earnings test on hours of work. In my research, I studied the response of workers to the earnings test by analyzing data on how much people work and earn, and how their behavior changed when the earnings test rules changed.[1,2] In 1978, the earnings limit was raised from $3,000 to $4,000 for workers aged 65-71, while it did not change for workers aged 62-64. In 1983, the earnings test was eliminated for workers aged 70-71, while it remained in place for workers aged 62-69. Lastly, in 1990 the earnings test tax rate was lowered from 50% to 33% for workers aged 65-69, but not for workers aged 62-64. The structure of each of these rule changes, affecting people of some ages and not other similar ages, is extremely useful. It allows us to control for other potential shifts in work hours by comparing earnings and hours of the affected and the unaffected age groups over the period when the rules changed.

The earnings data show that a significant proportion of workers respond to the earnings test and that they shifted their earnings when the rules changed. Figure 1 begins by showing earnings distributions *relative to the earnings limit* before and after the limit was raised for 65-71 year olds in 1978. The graphs compare the earnings of affected 67-69 year old men and of unaffected 63-64 year old men. Figure 1-A shows, before 1978, the number of older and younger workers with earnings in each $1000 interval above and below the earnings limit, as a proportion of the total number of people in the age group.

[1] In 1989 the Social Security Administration estimated that almost one million retired-worker beneficiaries lost some or all of their benefits to the earnings test, accounting for over one-third of people aged 65-69. In addition, about a couple hundred thousand beneficiaries kept their earnings just at or below the earnings limit. See Leonesio (1990) and Bondar (1993).

[2] The analysis is based on large data files collected for the Current Population Survey (CPS). People surveyed in the March CPS report their earnings and hours of work during the previous year. The data and methods are described in detail in Friedberg (2000).

Figure 1-A demonstrates a strong response to earnings test before any change in the rules. Many people in both age groups were clustered just at or below the limit – over 20% of 67-69 year old workers have earnings within $1000 below the limit, along with almost 10% of 63-64 year old workers. Roughly the same number of people appeared in each increment for several intervals, followed by a big drop from the interval just below to just above the limit.

FIGURE 1-A, 1975-77

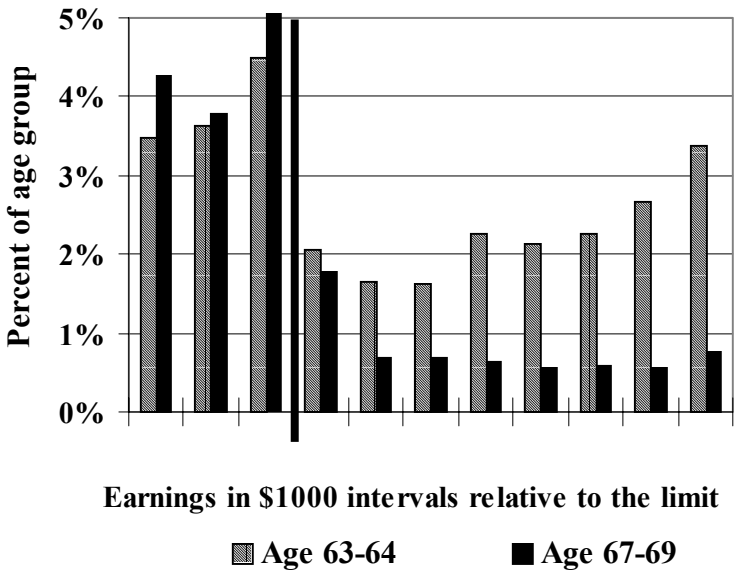


FIGURE 1-B, 1979-81

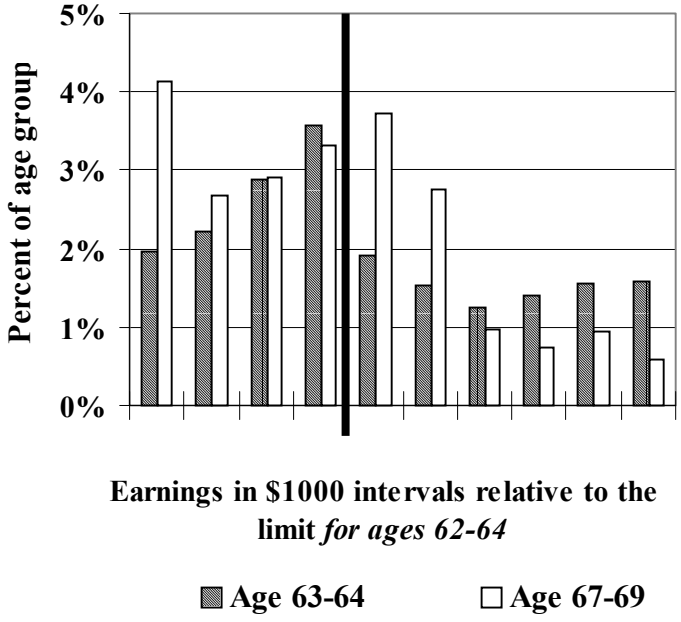
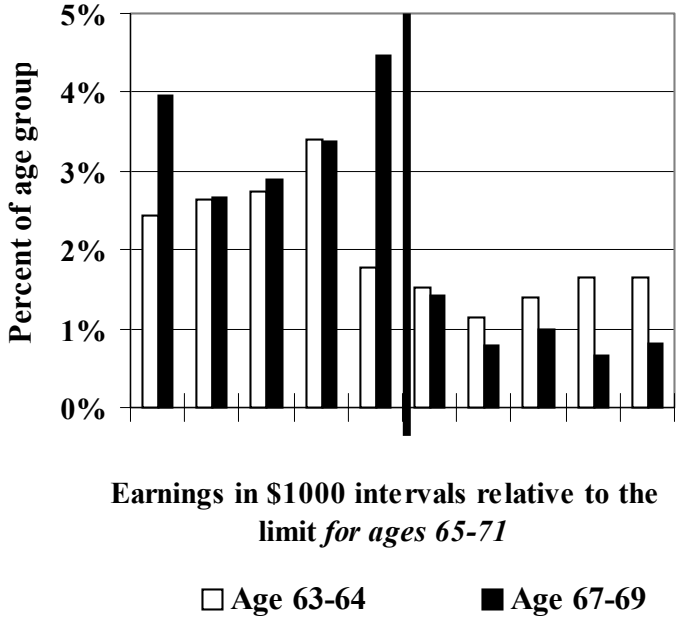


FIGURE 1-C, 1979-81



After 1978, the clustered 67-69 year olds moved up to the new earnings limit. First, Figure 1-B shows earnings of both age groups in relation to the *unchanged* earnings limit of the younger group. The 63-64 year olds kept their earnings at the same point, but the 67-69 year olds clearly shifted their earnings higher. Figure 1-C shows them clustered at their new higher limit. These changes were large and statistically significant.

Figure 2 makes the same comparisons around the earnings limit before and after 1983, when the earnings test was eliminated for 70-71 year olds. Figures 2-A illustrates earnings patterns before 1983 of the affected age group.[3] They are juxtaposed with 73-75 year olds who do not face the earnings test and whose earnings decline smoothly over the same range. Figure 2-B shows the same comparisons after 1983. Now, the earnings of the affected 71-72 year olds decline smoothly over the range of the earnings limit, resembling the older group.

There was no noticeable reaction to the 1990 reduction in the earnings test tax rate. This is not inconsistent with the other strong reactions, however, because the 1990 change was smaller. The tax rate declined 17 percentage points from 50% to 33%, rather than falling to zero as it effectively did earlier. Predictions based on those earlier response suggest a small, ambiguous change in earnings when the tax rate declines.

FIGURE 2-A, 1980-81

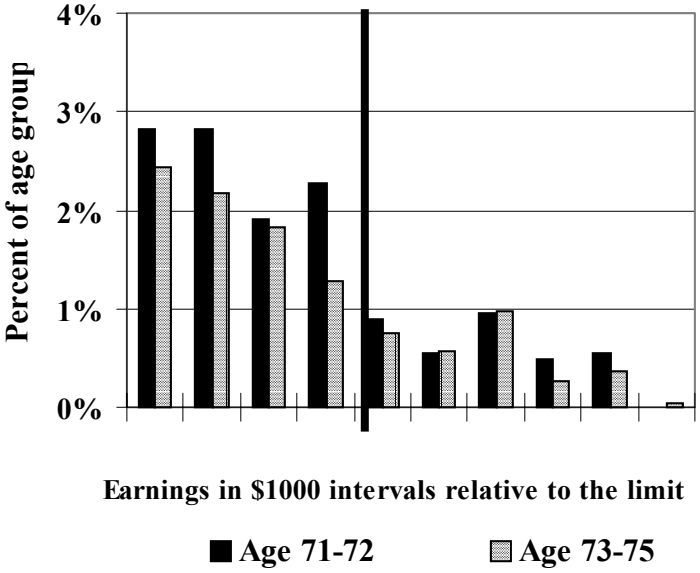
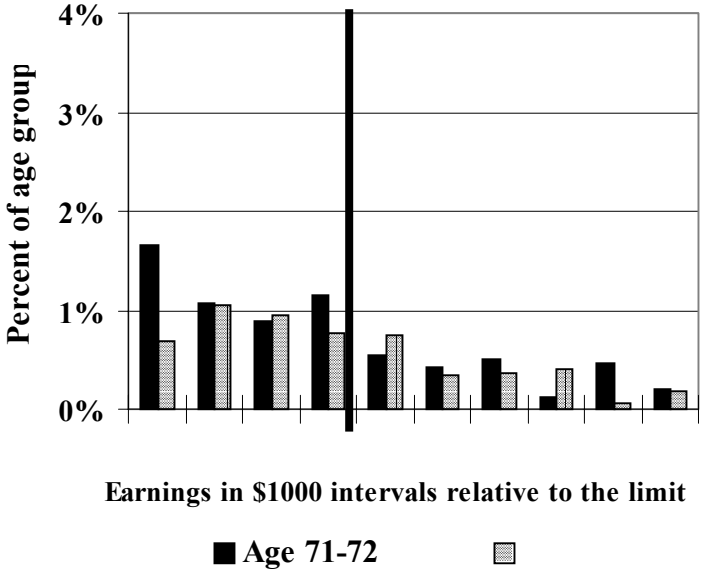


FIGURE 2-B, 1984-86



The data above show one particular reaction to the earnings test, among people keeping their earnings just at the earnings limit. Others working more and losing some or all their benefits to the earnings test will also react, but that reaction is more ambiguous and is thus difficult to observe above. The reasons are as follows.

[3] Figures 2-A and 2-B actually show 71-72 year olds, since they were 70-71 when the reported earnings were earned.

The earnings test alters the incentive to work in two different ways. It changes the net wage and also the total income of beneficiaries, depending on how much a beneficiary works. Although intuition suggests the earnings test causes beneficiaries to work less, this is not unambiguously true. Facing a higher marginal tax rate will cause people to work less, but reducing income may cause people to work more. Similarly, eliminating the earnings test will not lead all beneficiaries to work more. There are three different subgroups we have to consider, depending on how much someone is working when the earnings test is in place.

- The first group, low earners is the one discussed above, consisting of people who hold their earnings just at or below the earnings limit. They will unambiguously work more when the earnings limit is raised, the earnings test tax rate lowered, or the earnings test eliminated.

- The second group, medium earners, consists of people earning somewhat more than the limit and losing some but not all their benefits. In theory, we cannot unambiguously predict whether they will work more or less if the earnings test is relaxed or eliminated. They may work more because their marginal tax rate falls or less because they have extra income. My research shows that on average people in this group will work more.

- The third group, high earners consists of people earning considerably more than the limit and losing all their benefits. Their marginal tax rate will not change when the earnings test is eliminated, but their income will rise. This will induce them to work less, if they can adjust their hours of work.

What about the increase in benefits later on? Just as people are rewarded with higher benefits in the future if they delay claiming benefits today, beneficiaries also receive an increase in all future benefits for current benefits lost to the earnings test. Someone under age 65 gets a 6 2/3% increase in future benefits for each year's worth of benefits foregone. Someone aged 65-69 gets an adjustment that is gradually approaching 8%. These credits establish a tradeoff, actuarially fair for a person with average life expectancy, between a year's worth of benefits at present and a percentage increase in all future benefits.

However, there is no evidence that the credits are taken into account with regards to the earnings test. In all likelihood, many fewer people would respond to the earnings test and restrict their earnings, as we observe them doing in Figures 1 and 2.[4] Furthermore, descriptions of the earnings test in the popular press generally fail to mention the adjustment. When both *Money* (Simon 1996) and the *Los Angeles Times* (Kristof 1997) have described how the earnings test works, neither mentioned that higher future benefits compensate for lost benefits today. The perverse result is that people respond to the earnings test as if it were a tax, yet it raises virtually no revenue over the long-run.

The predicted impact of eliminating the earnings test. I used the information implicit in the response of workers to past changes in the earnings test to develop predictions about changes today, such as eliminating the earnings test or raising the earnings limit to $30,000.

[4] We would still expect a reaction among people with less than average life expectancy and people who are more impatient than average. Other evidence shows that more people claim benefits at age 62 than either of these factors predict, however, suggesting that people either do not know or do not care about the future adjustments.

Low earners, who keep their earnings just at or below the earnings limit are reacting most visibly to the earnings test and will be the most responsive to a change. Compared to their actual hours of work in 1995, they would be predicted to work 50% more on average, if the earnings test is eliminated. In comparison, medium earners would be predicted to work 18% more on average. As discussed earlier, they may work either more or less in theory because their marginal tax rate falls but their income rises. Thus, the evidence from past changes suggests that the tax rate effect dominates. Lastly, high earners would be predicted to work 4% less on average, because they have more income and their marginal tax rate does not change. In total, men aged 65-69 who were earning at least up to the earnings limit in 1995 would be predicted to work 5% more.

At this point, it is important to mention a caveat affecting high earners the most. These predictions have assumed that everyone can adjust their work hours flexibly. However, while those at the earnings limit do appear to have a lot of control over their hours, others who work full-time and earn more may have less flexibility. Thus, it is somewhat less likely that the group of high earners will actually change their hours, even though they are predicted to, compared to the low earners. This issue will also determine whether the earnings test affects retirement, as I discuss later.

It is interesting to compare the predictions of work hours if the earnings test is eliminated to the predictions when the earnings limit is raised to $30,000. Because this change is not as dramatic, people will not increase their work hours as much or will reduce their work hours more. The low earners would be predicted to work 34% more and the middle earners 7% more, while the high earners would be predicted to work 10% less. The differences arise because the tax rate gets pushed up onto higher earners. Raising the earnings limit removes the burden of the earnings test for many low earners but makes it bind more strongly for high earners.

One argument made against changing the earnings test is the fiscal cost. However, while the initial cost is relatively high, the long-run cost is declining towards zero, because benefits will not be lost today to the earnings test and thus future benefits will not be raised.[5] As these adjustments are approximately actuarially fair on average, the fiscal cost of eliminating the earnings test today will be virtually canceled out within a number of years.

Another possible argument against relaxing the earnings test is that it would primarily benefit high income beneficiaries. It is true that total income would rise more for high earners, but the data show that most of the distortions to behavior are observed among low and medium earners. Their work hours would rise the most if the earnings test were lifted.

Other potential effects. My research pertains directly to men aged 65-69 who are already working. Several other groups may be affected as well. I cannot offer as precise conclusions in their regard, but I will discuss some important considerations, and later I will discuss recent evidence about their reaction to the earnings test.

- It is essential to consider whether the earnings test induces people to retire. If jobs are perfectly flexible, then someone who wants to work but not lose benefits can limit their hours to

[5] Leonesio (1993) reported Social Security Administration forecasts that eliminating the earnings test for ages 65-69 would raise payouts by $4.3 billion in the first year. Income, payroll and benefits taxes due to higher earnings would offset 14.8% of the cost. That forecast was based on a very small predicted change in work hours. My research results suggest a larger offset through taxes paid as people work more.

keep their earnings below the limit. In that case, the earnings test will not cause anyone to retire completely. However, if jobs are not perfectly flexible, or if a part-time job involves a substantial cut in the hourly wage, then it may not be feasible to earn less than the limit, and retirement may be preferred to facing the earnings test. It is difficult to analyze the potential magnitude of such effects which depend on unobserved conditions of jobs, rather than on their observable work hours. Indirect evidence supports the notion that jobs are not perfectly flexible, so we might expect that eliminating the earnings test would cause some people to delay retirement.

- While my research focused on men, older women react similarly to the earnings test. Thus, we can expect a similar change in work hours if the earnings test is eliminated. A significantly smaller proportion of women work at these ages, though, so a smaller number will be affected.

- People aged 62-64 face much more restrictive earnings test rules, almost unchanged since the early 1970s. How do these younger workers respond? The data show that some hold their earnings just below the limit, as do older workers, while a greater proportion continue to work full-time. Therefore, more workers at these ages might reduce their hours, relative to older workers, if the earnings test is eliminated. However, it is among this group that the "retirement effect" of the earnings test is crucial. If the earnings test causes some 62-64 year olds to retire, eliminating it would have an extra punch because they are likely to continue working longer than 65-69 year olds.

Conclusions. The earnings test has been the subject of a great deal of popular attention, but less academic interest in recent years. I have used a new empirical strategy, analyzing the reactions to past changes in the earnings test rules, to arrive at several conclusions. The data reveal a significant number of workers clustered just at the earnings limit. The clustering demonstrates that the earnings test leads some beneficiaries to hold down their hours of work. The clustering moved when the earnings limit moved and disappeared when the earnings test was eliminated for some ages. Thus, many beneficiaries react promptly and flexibly to changes in the earnings test.

The past reactions indicate how people might respond if the earnings test is changed today. According to my estimates, men aged 65-69 who were earning at least up to the earnings limit in 1995 would be predicted to work 5% more, in total. Low earners, just at or below the earnings limit, would work 50% more, medium earners would work 18% more, and high earners would work 4% less. In comparison, people would be predicted to increase their work hours less or reduce them more when the earnings limit is raised to $30,000. These differences arise because the tax rate is not eliminated, but gets pushed up onto higher earners. Lastly, it is important to recognize that the long-run cost of eliminating the earnings test is virtually zero.

Research by others on the earnings test

A few recent studies of other countries (Canada, the United Kingdom) have found that eliminating earnings tests led to significant increases in labor supply (Baker and Benjamin 1999, Disney and Tanner 2000, Disney and Smith 2002). However, another study has taken a different approach to analyzing the earnings test in the U.S. Jonathan Gruber of MIT and Peter Orszag of The Brookings Institution used the same data but reached somewhat different conclusions (Gruber and Orszag 2000). They combined together all of the groups whom I just mentioned – low, medium, and high earners – to analyze whether overall labor supply changed.

Gruber and Orszag's key conclusions are the following. First, they suggested that the earnings test has little effect on hours of work. On the face of it, this contradicts my findings, but it may be attributable to a major drawback with their approach, which does not distinguish whether large responses among individuals are being obscured in the aggregate. Why is this important? We might reach very different conclusions if eliminating the earnings test induces no response by individuals, or instead if it induces large but offsetting responses. In the latter case, even though the earnings test leads some high earners to work less, the gain in well-being is substantial among low and medium earners who work more. My results showed that low earners who kept their earnings just at the earnings test limit were made worse off by an amount equivalent to over $1,900 by the earnings test. Thus, it is important to know how individuals, and not just average labor supply, is affected.

Second, Gruber and Orszag found that the earnings test may also induce some people to retire. They analyzed average labor force participation over time. Later on, I discuss some additional evidence supporting this conclusion. I focus instead on retirement rates specifically among those who have been working, in case re-entry into the labor force following a change in the earnings test is difficult. This is an important result for two reasons. First, if the earnings test also affects retirement, then estimates focused on hours of work understate its impact. Second, it tells us something important about how the labor market works – in particular, that people may not be able to choose their jobs and their hours very precisely.

Third, Gruber and Orszag argued that eliminating the earnings test for workers aged 62-64 would have a pernicious effect down the road on some people who would benefit from it at the outset. This argument is based on the adjustment to future benefits discussed earlier – if the earnings test is eliminated, those who would have lost benefits today, and also those deterred from claiming early today, would no longer get higher benefits in the future. The concern is that they would end up impoverished at a very old age. This argument rests on the following assumptions: that workers would prefer to save some or all of the higher benefits that they would get today if the earnings test is eliminated to consume at older ages, but that they would not actually save them, perhaps because they lack the means or the foresight. If those assumptions hold, then we could make them better off by getting them to save through the earnings test, but otherwise if they do not hold, forcing them to postpone receivingbenefits makes them worse off. Those are controversial assumptions about which we have little firm evidence. Gruber and Orszag mentioned that many people appear to claim Social Security benefits too early, given the roughly 7% real rate of return available for postponing; this, they suggest, supports the argument that people would be better off if compelled to postpone. However, another way to address the same concern – that too many beneficiaries would be induced to claim too early if the earnings test is eliminated – would be to try to explain to beneficiaries how Social Security works, and in particular that the return to delaying claiming benefits is substantial.

Recent effects of the earnings test. In preparation for this Forum, I have analyzed recent data on the impact of the earnings test. I find the following:

- Workers aged 62-64 continue to react to the earnings test, at the same time that more people at those ages are working instead of retiring.[6] The distribution of earnings at ages 63-64 is shown in Figure 3-A for men and in Figure 3-B for women. In the mid-1990s, roughly 4-5% of male workers were keeping their earnings within a range of $1,000 below the earnings test limit. In comparison,

[6] In my sample from the CPS, 41% of those aged 62-64 had positive earnings in 1991, while 48% had positive earnings in 2001.

only 1-3% of workers had earnings in other nearby $1,000 intervals. Women reacted a little more strongly, with 5-7% of workers keeping their earnings within a range of $1,000 below the earnings test limit. Interestingly, increases in the real value of the earnings limit after 1996 led to a little less clustering of earnings at the limit, so workers continue to show responsiveness to changes in the earnings test.

FIGURE 3-A
Male workers aged 63-64

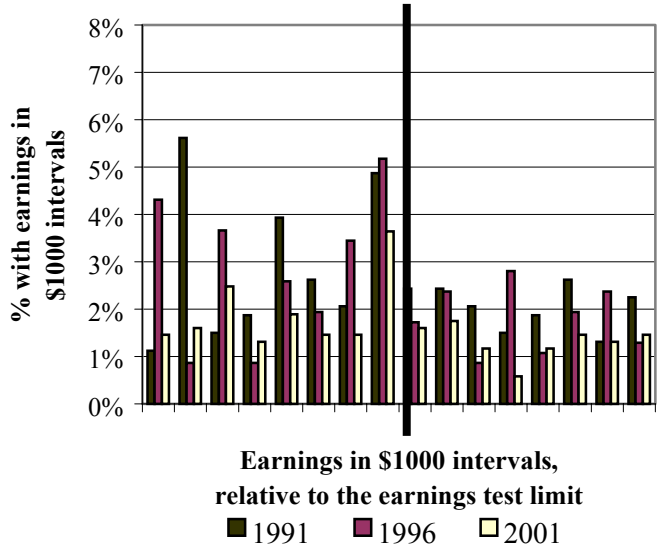


FIGURE 3-B
Female workers aged 63-64

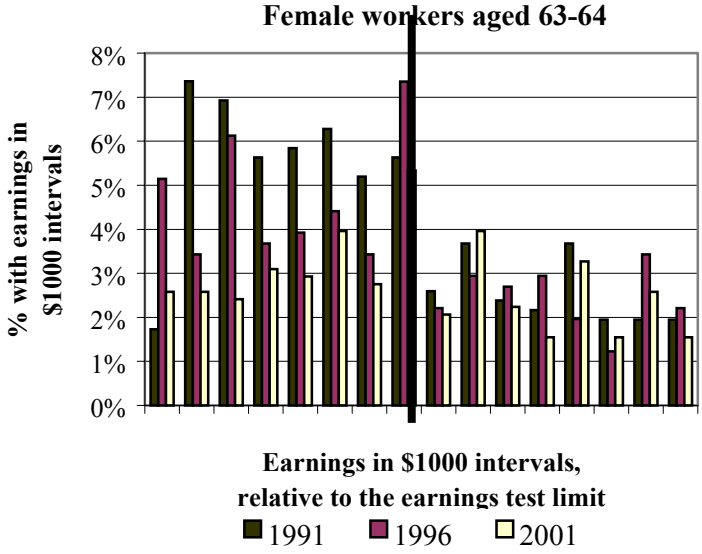


FIGURE 4-A
Male workers aged 67-69

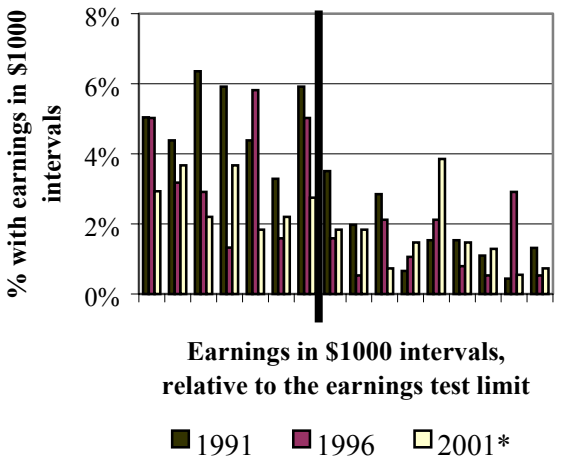
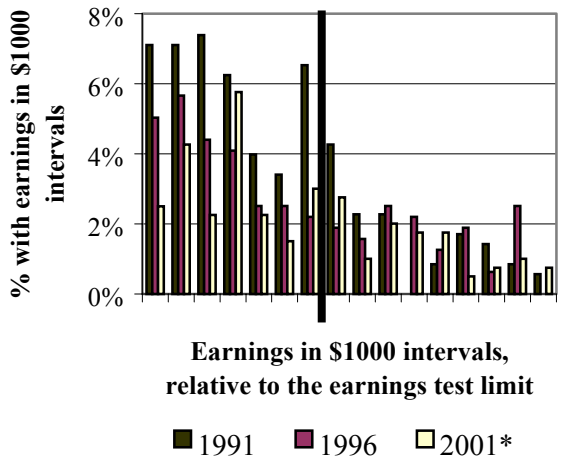
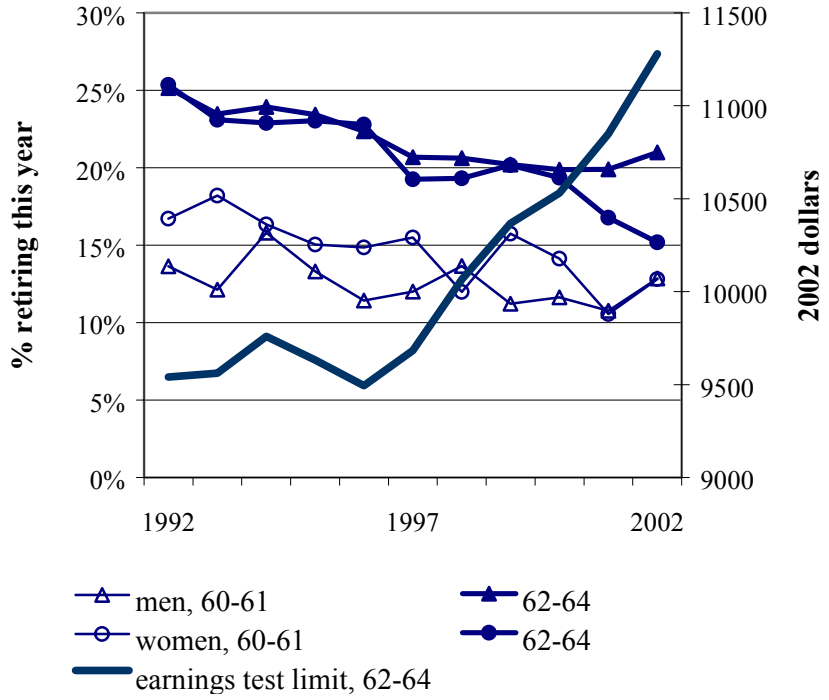


FIGURE 4-B
Female workers aged 67-69



* No earnings test in 2001; the limit applied in the data in 2001 is that from 1999.

FIGURE 5
% retiring this year, if working last year



- Workers aged 65-69 also continued to react to the earnings test, before it was eliminated in 2000. The distribution of earnings at ages 67-69 is shown in Figure 4-A for men and in Figure 4-B for women. The magnitude of clustering just at and below the earnings test limit began to diminish after the earnings limit was raised by $1,000 per year, beginning in 1996.

- I have mentioned a few times that the earnings test may lead some people to retire altogether. Figure 5 shows preliminary evidence in support of this. It shows the percentage of workers retiring by age, year, and gender. Three features stand out in the chart. First, there was little trend in retirement among workers aged 60-61 during the 1990s. Second, retirement rates fell among workers aged 62-64, especially from 1996 on. The percentage of male workers aged 62-64 who retired each year fell significantly, from about 25% to 20%, while the percentage of female workers fell from about 25% to 15%. Third, the earnings test limit for this age group rose in real terms from about 1996 on, from $9,494 in 1996 (measured in 2002 dollars) to $11,280 in 2002. Statistical analysis shows that these trends match up closely in timing. I will be conducting additional research in this area in the future to quantify the extent to which eliminating the earnings test would lead to delays in retirement.

Other factors affecting older workers. I have also done research showing the following:

- Older workers who learn to use a computer retire later, on average, than older workers who do not (Friedberg 2003). Yet, theory suggests that firms may be reluctant to train older workers, since they do not know when the workers will choose to retire.

- Older workers are engaging in part-time work at increasing rates, suggesting growing flexibility of the labor market in response to the needs and wishes of older workers (Friedberg 2001).

- Shifts in the structure of private pensions are having a major effect on retirement (Friedberg and Webb 2003). Traditional defined benefit pensions used to encourage workers to stay in a job 20-30 years to qualify for a substantial benefit, and then to leave because pension wealth is eroded by forgoing pension income. Defined contribution pensions, like 401(k), have none of these age-related incentives. We find that workers with defined contribution pensions are retiring two years later, on average, compared to workers with defined benefit pensions. It is also possible that defined contribution pensions will encourage older workers to take new, short-term jobs before retiring fully.

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